Sackers

TPR publishes DB investment guidance

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Introduction

The Pensions Regulator published new DB investment guidance on 30 March 2017.

The guidance is aimed at the trustees of occupational DB pension schemes, with a view to helping them understand, manage and monitor key aspects of a scheme's investment arrangements, objectives and strategy. The guidance aims to provide practical information for trustees, and includes examples of approaches that can be taken, and factors to consider, when investing scheme assets to fund DB schemes.

Key points

- **Governance:** TPR expects trustees to have suitably documented investment governance arrangements that are appropriate for a scheme's circumstances, including their level of complexity. They should enable effective and timely decision-making, focused on those decisions most likely to make a difference.
- **Understand risks:** trustees should understand, and mitigate where appropriate, the principal risks associated with implementing their scheme's investment arrangements. This will include operational risks, security of scheme assets, asset transitions, and liquidity and collateral management. Trustees should consider seeking appropriate protections to mitigate operational and security risks in their legal contracts with managers (including fiduciary managers) and custodians.
- **Environmental, Social or Governance (ESG):** most investments in pension schemes are exposed to long-term financial risks. Trustees are expected to assess the financial materiality of factors such as climate change, responsible business practices and corporate governance, and to allow for them accordingly in the development and implementation of a scheme's investment strategy. Governance of investments also includes stewardship activities. Where trustees have not developed and implemented their own policies, they should be familiar with their managers' policies and, where appropriate, seek to influence them.

Governance

The role of trustees

TPR explains that the fundamental purpose of trustees' investment powers is to generate returns, to enable a scheme to pay promised benefits as they fall due. To do this, trustees need to decide how scheme assets should be invested, at least at a strategic level.

The guidance outlines a number of elements which are necessary to achieve this, including the need to:

- be familiar with the basic legal principles around pension scheme investment, and the investment provisions of the scheme's governing documents
- delegate day-to-day investment decisions
- obtain relevant professional advice.

Taking advice

As the need to take advice is a legal requirement in certain circumstances, and may be something the trustees opt for in other situations, TPR outlines what trustees should take into account in ensuring the scheme's investments can be governed effectively. This includes being able to critically evaluate the main points of information received and understanding the key underlying assumptions.

Investment governance structures

Trustees need to have effective investment governance arrangements in place and for these to be suitably documented.

The guidance sets out examples of suitable structures, which might involve four parties: the trustee board, the investment consultant, the legal adviser and the investment manager. The structure used must allow effective decisions to be taken in a timely manner, by people or organisations with the necessary skills, knowledge, advice and resources.

For some schemes, having an investment governance committee can help a board's ability to take and implement effective investment decisions. However, the whole trustee board remains liable for its acts and decisions.

Fiduciary management

Given the increasing popularity of fiduciary management as an investment governance model, the guidance sets out a number of tips for trustees who are considering this as an option for their scheme. Among other things, it covers the due diligence needed to select a fiduciary manager, the need to check for and manage potential conflicts of interest between various parties (such as the scheme's existing investment consultant, third party advisers and the fiduciary manager) and the need to measure and monitor performance.

Clear roles and responsibilities

Whatever governance structure is chosen, all parties involved need to be "clear on areas where they make decisions, provide oversight, or give advice". This means ensuring clear terms of reference for any sub-committees and appropriate contractual arrangements with providers. TPR also suggests that trustees prepare a matrix, or table of accountabilities, to clarify the scheme's delegation and control structure.

Monitoring

Regular assessment by trustees of the effectiveness of their investment decision-making and governance processes is important to the overall success of their strategy. The guidance sets out a number of examples to help trustees with this, such as the need to consider whether they have enough advice and knowledge to enable considered and timely decision-making, and whether performance is delivered cost effectively.

Stewardship

Stewardship activities, such as engagement and the exercise of voting rights, are often undertaken by a scheme's investment manager on the trustees' behalf. The guidance explains the need for trustees to understand their managers' stewardship policies and to seek to influence them where appropriate.

Investing to fund DB

TPR also outlines a number of considerations to help trustees formulate, refine and revise their investment strategy.

Investment beliefs

One aspect is the suggestion that trustees develop and maintain a set of beliefs about how investment markets function and which factors lead to good investment outcomes. TPR explains that, investment beliefs, supported by research and experience, can help focus investment decision-making and make it more effective.

ESG

TPR refers to guidance by the Law Commission on the legal obligations that trustees have in considering financial factors (that is, any elements that are relevant to trustees' primary investment duty of balancing returns against risks) and non-financial factors (ie issues motivated by concerns other than trustees' primary investment duty, such as improving members' quality of life or showing disapproval of certain industries) when making investment decisions.

This includes the requirement to take into account factors that are financially material to investment performance, as well as the ability to take into account factors that are not financially material to the scheme. Where trustees consider ESG factors or ethical issues to be financially material, these should also be taken into account.

For more information on a practical approach to ESG for trustees, please see our guide for pension trustees.

Setting an appropriate investment strategy

A trustee board's investment strategy will set out how a scheme's assets are to be invested, balancing risk and return in light of evolving scheme circumstances and objectives over time. As such, it is one of the most important drivers of a scheme's ability to pay promised benefits. Trustees should therefore ensure that they allocate sufficient time and resource to it.

The guidance explains how to set objectives, including assessing risk capacity and setting risk appetite, as well as the need to work collaboratively with the scheme's sponsoring employer(s) in a bid to achieve better outcomes.

When setting the investment strategy, trustees should also consider the asset allocation and risk mitigations and how they expect these to evolve over time – what TPR refers to as "journey planning". This can help in setting a long-term investment plan.

Matching assets

Trustees are legally required to invest in assets backing DB liabilities in a way that is appropriate to the nature, timing and duration of the expected future retirement benefits payable under their scheme. As TPR explains, this is why many schemes hold “matching assets” in order to manage investment risk relative to the liabilities.

The guidance explains that trustees need to understand:

- the purpose of their matching assets, including the risks they are seeking to mitigate, in order to assess how appropriate and effective they are, and
- the risks introduced by those matching assets (eg around leverage and collateral management in LDI), to ensure they have appropriate strategies and governance arrangements in place to manage the risks.

Growth assets

As well as matching assets, pension schemes also hold growth assets, known as “return seeking investments”, with a view to getting a positive return over time to grow the scheme assets.

TPR explains how trustees can understand the risks that their growth assets are taking to seek return, including those in multi-asset funds and how to put in place appropriate methods, such as diversification and hedging, and appropriate governance arrangements to manage those risks.

Implementation

Once trustees have selected an investment strategy, they need to think about how it will be implemented. This includes considering operational risks, the security of scheme assets, asset transitions and liquidity and collateral management. TPR expects trustees to understand, and mitigate where appropriate, the principal risks associated with implementing their investment arrangements.

As identifying, understanding and mitigating implementation risks can be complex, TPR recommends that trustees take a proportionate approach and consider getting help from their advisers and investment providers.

In particular, TPR encourages trustees to obtain legal advice on managers’ fund documentation, to ensure awareness of the main features of the fund’s investment mandate and the principal risks inherent in the portfolio, including its liquidity arrangements.

Monitoring

Monitoring scheme investments is a key part of a scheme’s approach to integrated risk management. As such, trustees should monitor scheme investments as part of monitoring the employer covenant and scheme funding level, and consider the results together. To do this, trustees need to:

- focus on the key drivers of funding level change and investment performance, monitor them in a timely manner, and take appropriate action when necessary
- identify the key information that is needed to do this and ensure it is presented clearly, to facilitate effective well-informed decisions

- monitor the investment strategy, to assess whether investment returns and risk levels are within acceptable ranges and whether the scheme's investment objectives and any triggers remain appropriate

- make arrangements to monitor and review investment manager performance.

Actions for trustees

Trustees should familiarise themselves with the guidance and related publications, including the Trustee toolkit, which are linked to in the investment guidance.

As TPR explains, there are circumstances in which trustees need to seek professional advice to support their decision-making in relation to investment issues. Please speak to your usual Sackers' contact for help in this area.

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